How to trade ETFs

Exchange-traded funds are easy to buy and sell—they trade just like stocks

Exchange-traded funds have a lot going for them. They offer both the instant diversification of mutual funds, and the cost-effectiveness of stocks. But because they are a relatively new product, there is still a lot of confusion regarding how they are bought and sold.

One of the factors that makes ETFs an attractive low-fee option is that they are not sold through the adviser channel. That means ETF administrators don’t have to pay as much to market their funds, and they don’t have to pay sales commissions to advisers. But that also means that you’re often on your own when you buy and sell them.

Luckily, buying and selling an ETF is as easy as buying or selling a stock. As with stocks, ETFs trade on all the major exchanges, such as the Toronto Stock Exchange (TSX) and the New York Stock Exchange (NYSE). The main difference is that when you buy or sell an ETF, instead of trading a single stock, you’re trading a fund which can hold dozens or even hundreds of stocks. So you’re effectively trading a basket of stocks at once.

As with stocks, the prices of ETFs change throughout the trading day, while mutual funds are usually priced only once at the end of each day. And similarly to stocks, you make or lose money on ETFs depending on how their price changes while you hold them. If you buy an ETF for a higher price than you sell it for, you lose money. If you sell for more than you bought it for, you make money.
**Your first trade**

Buying or selling an ETF is similar to trading a stock, but if you’ve never used an online brokerage account, it’s easy to feel intimidated. To make things easier, here’s a step-by-step guide.

1. **Log on to your account**
   Open a discount brokerage account and log on to the secure trading site. Click on the link, tab or menu item that takes you to the entry form used to complete an order for a stock.

2. **Enter the ETF symbol**
   Enter the ETF’s ticker symbol. You may also have to select the exchange. If you don’t know the ticker, click on “Symbol Search.”

3. **Now enter the amount**
   Enter the number of ETF units you’d like to purchase. In addition to a flat trading fee ($5 to $29), you may be charged a commission based on the number of shares purchased (typically $0.01 to $0.03 per share), but this fee usually only kicks in for orders of 1,000 shares or more.

4. **Pick your trading order type**
   Decide which type of order to use. The default is a market order, which completes your purchase or sale at the prevailing market price. See “Learning the trades” on the last page for other order types.

5. **Set the time limit**
   Some online brokerages ask you to specify how long your order should be outstanding. The default is a day order, which lasts until the end of the current trading day. A good-till-cancelled (GTC) order remains open until you either fill or cancel the order, or 60 days pass.

6. **Review and submit**
   Once you enter the order you’ll be asked to review it. Do this carefully! Once you confirm, the order will be sent to the exchange to be filled.

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**Getting started**

To buy or sell ETFs, the first thing you need to do is open a brokerage account. You have two options: a full-service brokerage or a discount (self-service) brokerage. The full-service brokerage offers personalized service and advice from a client manager, but you pay higher trading costs of approximately $90 per trade, plus commissions. A discount brokerage account lets you buy and sell ETFs (as well as stocks, bonds and mutual funds) online or by phone. While there are no advisers to help you, the trading commissions are low, in the $5 to $29 range. The major online discount brokerages include Scotia iTrade, Questrade, CIBC Investor’s Edge, QTrade, TD Waterhouse, RBC Direct Investing, and BMO InvestorLine.

Once your account is up and running and you have deposited funds, you can start trading, but remember: every time you buy and sell an ETF you’ll incur a fee. If you have a small account, brokerage commissions can erode an ETF’s low-expense advantage, explains David Vomund, author of ETF Trading Strategies. For that reason ETFs are not ideal for portfolios worth less than $30,000, or for investors planning on using a dollar-cost averaging strategy, where you invest a fixed amount at regular intervals, such as every month. The good news is that the trading commission is usually fixed, so the higher the value of the trade, the lower the percentage cost. Because of that, ETFs are an excellent low-cost option for investors with larger portfolios.

**Tools of the trade**

Because ETFs trade like stocks, you can access many of the tools that stock traders use when placing orders. These can help you lock in gains and limit losses—advantages inherent to stocks but missing from mutual funds.

For instance, a “limit order” allows you to...
buy a certain number of units of an ETF at a specified price—a useful strategy when trading a low-volume ETF or in a highly volatile market. Using a limit order is a good idea if the ETF has a wide bid-ask spread—meaning a large gap between the buyer’s offer and the seller’s asking price. (For more on different trading orders and how to use them, see “Learning the trades” on the next page.)

However, most buy-and-hold ETF investors are interested in the larger, highly liquid ETFs. If that’s the case, simply selecting the right funds for your portfolio and using the default trading order—a market order—will be just fine, says Richard Ferri, CEO of Portfolio Solutions, and author of The ETF Book.

Narrowing the field
There are more than 200 ETFs trading on the TSX, plus hundreds more available to Canadians on U.S. exchanges. Finding the ETF you’re after in such a crowded marketplace can be daunting, but there are online tools that can help. To help sort and filter ETFs, it helps to think of them as falling into three broad groupings: passively managed, actively managed, and screened.

If you’re just starting to use exchange-traded funds, passive ETFs are the easiest to understand. They simply attempt to replicate an index that tracks a broad market or specific sector, such as the S&P/TSX 60, the S&P 500, or the S&P/TSX Global Mining Index.

Actively managed ETFs, on the other hand, are not much different from traditional mutual funds: they employ fund managers who select individual securities they think will outperform the market. Such an ETF may specialize in dividend stocks, for example, but it might also hold cash and bonds if the manager chooses.

Screened ETFs—sometimes called strategy ETFs—fall somewhere in between. They start with a broad index, but then filter out securities that do not meet certain criteria. For example, an ETF may use a methodology that selects only companies which have increased dividends over the last five years, or it may alter the weighting of stocks in the portfolio according to certain rules.

To help you screen funds that meet your investment criteria you can use online tools, such as the Toronto Stock Exchange’s ETF Screener. (See “Zeroing in on the right ETF for you,” to the left, for a list of useful tools.)

If you’re a buy-and-hold investor, and you want the widest possible diversification, you should stick with broad-market ETFs for the core of your portfolio, says Ferri. Then you can branch out and add an ETF or two that concentrates on a specific sector.

Know the risks
Even though ETFs offer instant diversification, better tax efficiency, and transparency (in both holdings and investment strategy), as with all investments, there are risks.

You should keep in mind that studies show that the typical individual investor has a poor record when it comes to timing the market. Since ETFs can be bought and sold throughout the day, there is a danger that you’ll be tempted to trade too frequently. “The potential to undermine yourself with trading is very real, and you don’t have to trade a whole lot in order to sabotage a good ETF investment,” explains Morningstar.

You have options
More advanced traders can use put and call options with their ETFs. A call option is a contract that gives the buyer the right, but not the obligation, to buy an ETF at a specified price (called the “strike price”) by a certain date. A put option gives the holder the right to sell an ETF at a certain price within a specific period.
LEARNING THE TRADES

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<tr>
<th>ORDER TYPE</th>
<th>DESCRIPTION</th>
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<tbody>
<tr>
<td>Market order</td>
<td>The default order. This order will attempt to complete your trade as soon as possible at the best available current price.</td>
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<tr>
<td>Limit order</td>
<td>This order lets you set a maximum price when you buy and a minimum price when you sell. You can also specify the length of time you want the order to remain open.</td>
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<tr>
<td>All or none order</td>
<td>An order that will only be executed if all of the specified number of units can be bought or sold. If only a portion of the order could be filled at the specified price, the entire order remains unfilled.</td>
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<tr>
<td>Stop loss</td>
<td>An order to sell a security when its price falls to a certain level. This order is designed to limit your loss in a position.</td>
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<tr>
<td>Trailing stop</td>
<td>A stop-loss order that is set at a percentage below the market price. The sell price for this order will move as the price of the security fluctuates. This type of order is designed to capture gains and cut losses at the same time.</td>
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**The ETF Advantage: Part II**

At the end of day (especially during the last hour of trading) large designated investors begin to hedge their positions, which can result in rapid pricing changes and wide bid-and-ask spreads.

For long-term investors, Ferri suggests sticking with funds that have a narrow spread between the bid-and-ask price and funds that have good liquidity. Ferri also suggests sticking with market orders—the default trading order—until you become more comfortable with the process. By keeping it simple and riding out market swings you can take advantage of the low fees and stable returns offered by most ETFs and create a well diversified, long-term portfolio.

**HOW ETFs are priced**

Like a mutual fund, an ETF has a net asset value (NAV), which is calculated at the end of each trading day. However, since ETFs are traded on a stock exchange, these funds also have an intraday market price that reflects supply and demand for the ETF. This intraday price is published every 15 seconds throughout the trading day.

A mutual fund’s “NAV per unit” is the price that an investor will pay to buy or sell the fund from the investment company. For ETFs it works a bit differently. The NAV will indicate the value of the ETF based on the value of its underlying basket of assets. However, the amount you pay to buy units of the ETF will be determined by the intraday price. The bigger the spread between an ETF’s NAV and its intraday value, the larger the fund’s volatility and risk.